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Q&A-Brazil's econ outlook dour without reforms; Govt. action needed to boost energy transition, cenbank can support: Arminio Fraga, former c.bank governor



Brazil's economic outlook appears bleak unless the government implements structural reforms and instills confidence in the state's financial health, **Arminio Fraga, former governor of the country's central bank**, told the Reuters Global Markets Forum on Wednesday, September 1.

A growing fiscal deficit, lack of inclusive and sustainable growth, political unrest together with the lingering impact of 2014's recession weigh on Brazil's growth and investment, he said.

Fraga, who led Banco Central do Brasil from 1999 to 2002, believed it was up to the government to "take real action" to boost the energy transition process, and that the central bank can only play a supporting role. "We're going to have to speed up these efforts"

Following are edited excerpts from the conversation:

Q: What's your view on Brazil's economic recovery and what are the biggest systemic risks that need to be addressed?

A: Going back to the beginning of the pandemic, there was quite a lot of government spending put in place -- GDP (gross domestic product) revisions are due to that. The main problem going forward goes beyond the pandemic. Sticking to the pandemic for now, Brazil was a bit late, but thanks to the network of the public health system, the vaccination has been taking place at a good pace. People in Brazil want to get vaccinated. It is my view that we Brazilians, from the very rich to the very poor, want no part of this pandemic. We've quickly figured out that we have to protect ourselves despite the unfortunate leadership example that was set.

As far as the economy is concerned with that backdrop, the GDP numbers for this year were revised up substantially from the original early forecast. The issue is now going forward, what will happen? There the outlook is not so good. Since 2014, when we collapsed into a massive recession on our own, that was completely homemade, we haven't fully recovered. There's been a reform effort in place, but there's something bigger missing. That, I think, can be summarized in the word 'confidence'. There's still no confidence in the future, the general political outlook still remains scary. We are one of many countries in the world where the issue of polarization takes a toll. There is also the important matter of the financial health of the state.

Since 2014 we lost what was then our main anchor, which was a consistent and reasonably large primary surplus of the government. So, the debt dynamics were reasonably well-behaved. Since then, we've gone underwater and had a primary deficit. Because we have reasonably higher interest rates, the Brazilian TIPS (Treasury Inflation-Protected Security) are 4.5%. We have to watch it. Politics, lack of a general vision of the future that is conducive to sustainable growth and inclusive growth is lacking. What most foreigners tend to see in Brazil, used to be the Amazon, where we have been doing quite well for years, and it's been a U-turn -- rates of deforestation have gone up. In politics, we're burning with populism and demagoguery, and a sense of disregard for our democracy. It's an overall package that has kept investment very low in Brazil, for quite some time. For 30-40 years, Brazil's rate of growth has been pretty similar to that of the advanced economies. So, we're not converging, and this is really mediocre. It's low and highly volatile growth -- it goes beyond the pandemic and short-term cycles.

Q: Is Copcom's current policy trajectory enough to bring inflation under control, and does it have room to maneuver?

A: Unlike the more mature economies that have been afraid of deflation, that hasn't been the case in Brazil. The central bank was rightly quite aggressive in cutting rates to levels we had never seen, but now they're catching up. While there are elements that are temporary, we are not at a situation that is fully under control yet. The fiscal policy and the finances of the state play a role -we have a reasonable monetary anchor system in place with inflation targeting. So, you start to hear words like fiscal dominance, it basically means you're caught with a short blanket -- if you raise rates, the debt dynamics get hit. At the moment this can be seen particularly in the exchange rate. Brazil has been benefiting from good terms of trade -- export markets are booming. We've also benefited from pretty much free money in the planet. But despite that, the currency is undervalued. But if you think of the capital account, the story is different. Yes, as the central bank engaged in in a tightening cycle, the currency strengthened a bit, but it's still in a zip code that suggests the problems that I alluded to earlier are in play.

Q: Will the government be able to avert breaking its spending cap? What kind of fallout do you expect if it is breached?

A: The spending cap was a very bold move on our part, and it reflects the fact that government spending has been growing here for decades as a ratio of GDP -- it's been up about 10 points of GDP for over 30 years. It's interesting and worrisome that during those same years, government investment went from 5% to 1% of GDP and the government investment is included in the overall spending. So, the ceiling has played a role. But over time, if other reforms are not put in place, if spending priorities are not changed, things will become dysfunctional. There's some pressure on the cap as we speak, and we'll have to see. As of now, it's still holding but there are exceptions. The constitutional amendment that introduced the cap allows for spending in extreme circumstances such as the pandemic, so that the money is spent on that front -- we're talking 15%-20% of GDP. It does mean however, that the debt is higher -- I would say that the ceiling is now being attacked by accounting gimmicks.

Over the years, government spending in Brazil has become very concentrated on payroll and social security, that accounts for about 80% of spending. This is a total outlier, if you compare it to pretty much any country in the planet. So, the ceiling is making things somewhat dysfunctional. As time goes by, the pressure will only grow unless spending priorities are not revisited. What we're seeing right now goes beyond that sort of a medium-term thing. Because now the government is really putting the ceiling as something that is forcing them to honor some of these legal debt versus increasing the spending on Bolsa Familia. And that of course, is a politically smart way to put it. But it's the old-fashioned syndrome of inverted priorities. But yes, the ceiling is under pressure and in many ways, it is becoming dysfunctional. It is smack in the middle of electoral politics right now. So we'll have to see -- this is a tricky situation.

Q: Do you see progress on tax reform this year? What other reforms would boost long-term growth and fiscal credibility?

A: On the productivity front, you have sitting before Congress a proposal to reform our VAT (value added tax), which is a nightmare. Brazil has 27 states -- each has its own VAT rules -- it is crazy. That is a very important reform from the standpoint of growth, and it's just sitting there. It does involve issues of the Federation, which makes it tricky. Then you have a proposal to change the income tax that the government presented in a way that makes sense, because there are a lot of loopholes for the rich. They said, we're going to close these loopholes and we're going to increase social spending -- which was quite reasonable, unlike many things this government has been doing. But that ran into a wall of political resistance from those who benefit, as is typically the case with taxes. Vocal powerful minorities get in the way. As of now, it seems to be going nowhere, because strong lobbying against it got in the way.

Now, you asked me what else needs to be done, and I go back to the 80% number that I mentioned to you. If 80% goes into a payroll and social security, Brazil could find some four or five points of GDP, with state reform and further efforts on social security. Then there's the world of subsidies where I believe we're talking about another three points of GDP. That ought to be mobilized through reforms. All of these are running into not only organized, powerful lobbies, but I believe, also the President's attitude -- he never backed any of these reforms. That makes it very hard for this to happen. So, we have a major effort ahead of us at some point, that would be both important for making Brazil grow faster, and to help reduce our immense inequality -- both from the standpoint of where the spending goes, and from how the revenues are collected.

Q: If former President Luiz Inacio Lula da Silva is re-elected, what impact do you see on Brazil's economy and markets?

A: If we see the Lula of his first term, I'd say you'd have conventional, social democratic policies in place. One eye on inequality, one eye on growth, looking for balance, and that will be positive. If we see the Lula of his second term in the loop and the Lula of the successor he handpicked -- then we're in trouble. We'll have to see what he comes up with. But it's a very clear jump from Lula.1 to Lula.2, and (former President) Dilma Rousseff. You have to remember Dilma was already his chief of staff -- she had been minister of energy, then she became his chief of staff. So those were his policies, he will of course deny it now, but that is the truth. So, we're between the horror of the current government that goes beyond economics, and fiasco of the workers party in power, despite Lula's terrific efforts of his first three years.

Q: As Brazil and other emerging markets (EM) double down on oil, what should the thinking be on energy transition?

A: First, clearly, we're going to have to speed up these efforts. It means carbon, it means technology, it means everything. We're getting too close to the edge. We see other countries with goals for 2050, that's way too far -- we have to tighten up that calendar. In the case of Brazil, we could be a green paradise. At some point, we're going to figure out that that is not only good for the world's climate change efforts, but it's also good for us. We're talking quality of life and that's a future attraction. Sadly, I don't see the current government doing much on this front, but I do see from the bottom up here growing awareness of how this could be super important for Brazil and they would go beyond the carbon accounting -- including on oil. We've found a lot of oil -- what do we do? Other countries have had to deal with a similar situation -- Norway, famously. I do see technological advances that have been allowing us to benefit from solar and wind, biofuels, gas etc... I'm big on a green revolution. We see spontaneous growth in areas that have been devastated in the Amazon. The picture right now is terrible, hopefully the movie will be better.

Q: What role, if any, do you think the central bank should play here - purchasing green bonds like the ECB?

A: They can try, but that is second or third order. The real work is not going to happen at the central bank. They're going to try and be good citizens and do their bit. But it's up to the government to take real action. We can't rely on central banks to take that action.

Q: What does the energy transition mean for state-owned oil companies like Petrobras?

A: All these oil companies are thinking hard about their future. I think Petrobras has excellent staff, it has had problems with its governance, its owner -- it hasn't been the best owner. They need to think hard about the future, because at some point, we're going to figure out that fossil fuels have to go away. We do know that the impact on the atmosphere is cumulative, so postponing helps a bit, but doesn't really solve the problem. At some point, we're going to have to stop -- we're nowhere near that. The CEOs of many of these companies (are) well aware of this. They're trying as best as they can to prepare, but it's not going to be easy for them.

Q: What steps does the government need to take to wean off resource and China-oriented dependence in the years ahead?

A: Yes, we export commodities, but that is not a big slice of our GDP. When there's a boom, maybe that gets us another point in growth. We need to get another three or four points, and that will come from education, a higher investment ratio, tax reform, etc. I think we cannot blame the cycle for our fortunes. It might apply to an agricultural economy, it's not the case. We've got a lot of work to do -- put education on top of the list and then more investment right next to it. Next to that, all the inequality related issues, productivity issues, and you'll have a Brazil that ought to be growing at 4% a year or more at least for a few couple of decades. It should be a no brainer to do from a technical standpoint.

Q: With reduced agricultural output expected after the recent shock frost, are effects of lower exports priced into the real?

A: I think they're priced in; the action is more on the capital account.

Q: What impact do you expect on EMs when developed nations start tapering and tightening policy?

A: That's a classic, and we'll see it. The one thing I have to say gives me a little bit of comfort that this may not be as dramatic as it has been in the past, is floating exchange rates. I think at least the exchange rates can do some of the jobs. In the old days of fixed or managed rates, governments would get into a squeeze and it will typically lead to a crisis. The floating exchange rates does act as a shock absorber, which is a plus. The other is the financial sector. I would say in the case of Brazil, the financial system is healthy. Let's say real rates go into positive territory in the advanced economies and commodities come down, Brazil will be hit but that shouldn't be enough to derail things completely. What bothers me is that instead of steadily growing at 4% a year and then for a year or two down to 2%, if you're growing at 1% or 2% a year -- the pain is greater if such a shock were to hit. I still think the two shock absorbers that I mentioned would help it be less and save them the famous debt crisis of the 1980s.

Q: What are your views on cryptocurrencies? How would the plan for a digital real interact with traditional crypto?

A: Let's keep crypto and digital separate. I think the digital is here. It's fascinating to see the Central Bank of Brazil doing well, I'd say they're ahead of the curve on that aspect. The crypto side is a little tricky, it is a sort of frothy, bubbly environment. I'm not of the libertarian view that this is a necessary thing. I think any country that has a reasonably well-functioning state ought to have its own currency because it's much cheaper than the crypto versions, it's safer -- cryptocurrencies fluctuate like crazy. So, they're not real and are not appropriate currencies for the functioning of an economy. They're (a) more speculative animal. I'm not big on crypto. You can speculate all you want on it, but thinking as a former policymaker, that's not going to do anything for us.

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